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6 **BEFORE THE**
CALIFORNIA BOARD OF ACCOUNTANCY
7 **DEPARTMENT OF CONSUMER AFFAIRS**
8 **STATE OF CALIFORNIA**

9 In the Matter of the Accusation Against:

Case No. AC-2006-28

10 **KPMG LLP** (In re: Tax Shelters)
355 South Grand Avenue, Suite 2000
11 Los Angeles, CA 90071
CPA Partnership Certificate No. PAR 157,

ACCUSATION

12 Respondent.
13

14 Carol Sigmann, the Complainant herein, alleges:

15 **PARTIES and JURISDICTION**

16 1. The Complainant herein, Carol Sigmann, brings this Accusation under Business and
17 Professions Code Section 5100 solely in her official capacity as the Executive Officer of the
18 California Board of Accountancy, Department of Consumer Affairs ("Board").

19 **License Information**

20 2. On or about February 10, 1949, the Board issued partnership certificate number PAR
21 157 to Peat Marwick Mitchell & Co. Subsequent name changes, described in the accompanying
22 footnote, have resulted in the license being held by KPMG LLP.¹ The certificate is renewed
23 through February 28, 2009. Respondent KPMG LLP will be referred to herein as "KPMG" or
24 "Respondent."

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26 1. The Board approved two name change requests which resulted from mergers for
27 certificate number PAR 157: on June 3, 1987, a name change was approved, to Peat Marwick
28 Main & Co., and on June 1, 1990, a name change was approved, to KPMG Peat Marwick.
Subsequently, on October 14, 1994, the Board approved a name change to KPMG Peat
Marwick LLP to reflect its change in status to a "limited liability partnership." A subsequent
name change to KPMG LLP was approved, effective March 26, 1999.

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granted, or may censure the holder of that permit or certificate, for unprofessional conduct which includes, but is not limited to, one or any combination of the causes specified therein, including, in pertinent part:

5100(c) Dishonesty, fraud, (or) gross negligence...in the practice of public accountancy.

5100(g)	Willful violation of the Accountancy Act or a board rule promulgated thereunder.
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5100(j) Knowing preparation, publication, or dissemination of false, fraudulent or materially misleading financial statements, reports, or information.

5. Code Section 5101 provides, *inter alia*, that a partnership permit may be disciplined for any of the causes enumerated in Code Section 5100.

6. Code Section 125 provides in pertinent part that a Board licensee is subject to the disciplinary provisions of the Business and Professions Code applicable to him or her when s/he conspires with a person not so licensed to violate any provision of this code, or who, with intent to aid or assist that person in violating those provisions allows his or her license to be used by that person or acts as his or her agent or partner.

7. Licensees are required by Board Rule 5 to comply with all Board rules, including Board Rule 58, which provides that licensees engaged in the practice of public accountancy shall comply with all applicable professional standards.

Applicable Professional Standards

8. Professional standards or standards of practice pertinent⁶ to this Accusation include, without limitation:

A. The Internal Revenue Code, including:

(1.) 26 U.S.C. §6111 ("Section 6111"), which governed the registration of tax shelters.

(2.) 26 U.S.C. §6112 ("Section 6112"), which imposed certain obligations on the organizer or seller of a "potentially abusive tax shelter."

6. All references herein to standards and other authoritative literature are to the versions in effect at the time the tax shelters were being developed, marketed or sold.

(3.) 26 U.S.C. §6662 ("Section 6662"), which imposed significant penalties on taxpayers for the understatement of income tax, for example, where the relevant facts affecting an item's tax treatment were not adequately disclosed in the return and where there exists no reasonable basis for the tax treatment, or where there existed no basis for a reasonable belief that tax treatment of a tax shelter was more likely than not the proper treatment.

B. Title 31, Part 10 of the U.S. Treasury Department Regulations (31 CFR 10)⁷ including:

(1.) Section 10.21 Knowledge of Client's Omission. 31 CFR 10.21 provides that:

"[a] practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission."

(2.) Section 10.22 Diligence as to Accuracy. 31 CFR 10.22(a) provides that, in general, a practitioner must exercise due diligence...

"(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service."

(3.) Section 10.34 Standards for Advising with Respect to Tax Return Positions and for Preparing or Signing Returns. 31 CFR 10.34(a) provides that a practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the "realistic possibility standard") unless the position is not frivolous and is adequately disclosed to the Internal Revenue

7. 31 CFR 10 is also referred to as "Circular 230" or Section 10 of the IRS Regulations. Among other things, Circular 230 governs practice by CPAs before the IRS.

1 Service.

2 C. American Institute of Certified Public Accountants (AICPA) *Code of Professional*
3 *Conduct*, which includes Section I - Principles and Section II - Rules. Both the Principles
4 (Articles III and VI) and the Rules are relevant to the allegations herein. For example, Rule 102
5 (Integrity and Objectivity), provides that:

6 "In the performance of any professional service, a member shall maintain
7 objectivity and integrity, shall be free of conflicts of interest, and shall not
8 knowingly misrepresent facts or subordinate his or her judgment to others."

9 D. *AICPA Statements on Standards for Tax Standards*⁸, including:

10 (1.) TS Section 100 - Tax Return Positions. For example, a member should not
11 recommend that a tax return position be taken with respect to any item unless the member has a
12 good-faith belief that the position has a realistic possibility of being sustained administratively or
13 judicially on its merits if challenged. TS Section 100.02a.

14 **Cost Recovery**

15 9. Code Section 5107(a) provides in pertinent part that the Executive Officer of the
16 Board may request the administrative law judge, as part of the proposed decision in a disciplinary
17 proceeding, to direct any holder of a permit or certificate found to have committed a violation or
18 violations of the Accountancy Act to pay to the Board all reasonable costs of investigation and
19 prosecution of the case, including, but not limited to, attorneys' fees incurred prior to the
20 commencement of the hearing. A certified copy of the actual costs, or a good faith estimate of
21 costs signed by the Executive Officer, constitutes prima facie evidence of reasonable costs of
22 investigation and prosecution of the case.

23 **Public Protection**

24 10. Code Section 5000.1 provides as follows: "Protection of the public shall be the
25 highest priority for the California Board of Accountancy in exercising its licensing, regulatory, and
26 disciplinary functions. Whenever the protection of the public is inconsistent with other interests
27 sought to be promoted, the protection of the public shall be paramount."

28 8. The *AICPA Statements on Standards*, Tax Standards, are codified as "TS" with section
numbers, e.g., TS Section 100.

BACKGROUND

Licensee KPMG and Subject Matter

11. At all times relevant to this Accusation, Respondent KPMG was a limited liability partnership headquartered in New York, New York, with more than 90 offices nationwide, of which several are in California.⁹ KPMG was one of the largest auditing firms in the world, providing audit services to many of the largest corporations in the United States and elsewhere. KPMG also provided tax services to corporate and individual clients, some of whom were very wealthy. These tax services included, but were not limited to, preparing federal and state tax returns, providing tax planning and tax advice, and representing clients, for example, in Internal Revenue Service ("IRS") and Franchise Tax Board ("FTB") audits, and in Tax Court litigation with the IRS.

12. The subject matter of this Accusation is KPMG's involvement, through certain of its partners and employees, in developing, promoting and implementing unregistered and fraudulent tax shelters. From 1996 until 2002, KPMG, through its tax partners, assisted high net worth United States citizens to evade United States individual income taxes on billions of dollars in capital gain and ordinary income by developing, promoting and implementing these tax shelters. A number of KPMG tax partners engaged in conduct that was unlawful and fraudulent. Several tax partners alleged to be central to the design and implementation of the tax shelter schemes occupied, during some part or all of the relevant time period, various leadership and management positions in KPMG's tax practice and at the highest levels of the firm.¹⁰ Significant activity and

9. Among the California KPMG offices during the time period relevant herein were Los Angeles, Woodland Hills, San Diego, San Francisco, and Walnut Creek. KPMG is and was a member firm of KPMG International, a Swiss cooperative of which all KPMG firms worldwide are members.

10. The portion of KPMG's tax practice that specialized in providing tax advice to individuals, including wealthy individuals, was known as Personal Financial Planning, or "PFP." The KPMG group focused on designing, marketing, and implementing tax shelters for individual clients was known at different times as **CaTS** ("Capital Transaction Strategies"), and **IS** ("Innovative Strategies"). The KPMG group focused on designing, marketing, and implementing tax shelters for corporate clients was known as **Stratecon**. KPMG also had a department within its tax practice known as Washington National Tax ("**WNT**") which was

(continued...)

1 coordination regarding the design and implementation of the tax shelters took place at the
2 national, regional, and state levels, much of it by California licensees or on behalf of California
3 taxpayers.

4 **Roles of KPMG Firm Members and of Other Pertinent Individuals and Entities**

5 13. During the relevant time period, KPMG, by and through several of its partners and
6 employees or former partners or employees, among them California licensed CPAs as well as
7 some who were officed in California but not licensed as CPAs, and others, participated in the tax
8 shelter strategies. Those persons participating in tax shelter strategies while employed by KPMG
9 may be referred to herein as "KPMG tax personnel" or "KPMG personnel."

10 14. KPMG personnel also formed alliances, operating agreements, and/or joint ventures
11 with outside persons, including former partners, employees, and others ("promoters"). For
12 example, former KPMG personnel formed purported "investment advisory firms," sometimes
13 referred to as "boutique practices," - at least one of which was located in California - to assist in
14 implementing the tax shelter schemes. KPMG also worked with law firms/lawyers to implement
15 these tax shelter transactions. In addition, KPMG worked with banks (of which three were audit
16 clients of KPMG) in implementing the tax shelter transactions. These persons and entities may be
17 referred to herein as "others" or "associates."

18 **The Fraudulent Tax Shelter Activities**

19 15. The law in effect from at least in or about August 1997 provided that if a taxpayer
20 claimed a tax benefit that was later disallowed, the IRS could impose substantial penalties, ranging
21 from 20%-40% of the underpayment of tax attributable to the shelter, unless the tax benefit was
22 supported by an independent opinion relied on by the taxpayer in good faith that the tax benefit
23 was "more likely than not" to survive IRS challenge.

24 16. During the period from at least in or about 1996 through at least in or about 2002,
25 Respondent KPMG and some of its tax personnel and their associates:

26 A. Developed, marketed, and implemented unregistered and fraudulent tax shelters;

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28 10. (...continued)
designed to provide expert tax advice to KPMG professionals in the field, and which
participated in designing tax shelters and drafting opinion letters relating to those shelters.

1 B. Prepared false and fraudulent U.S. individual income tax returns for shelter clients;
2 and

3 C. Actively took steps to conceal from the IRS those shelters.

4 17. Respondent KPMG, and KPMG tax personnel and associates, designed and marketed
5 these shelters as a means for wealthy individuals with taxable income or gains, generally in excess
6 of \$10 million in 1997 and in excess of \$20 million in 1998-2000, to reduce or eliminate their
7 individual income taxes to the IRS and state taxing authorities on that income or gains. As
8 marketed and implemented by Respondent KPMG and KPMG tax personnel, instead of the
9 wealthy clients paying U.S. individual income taxes that were legally owed, generally 20% to 35%
10 of their income or gains, the tax shelters enabled the client to choose the amount of tax loss
11 desired, and pay certain persons and entities, including KPMG, an "all-in" cost generally equal to
12 approximately 5% to 7% of the desired tax loss.

13 18. The "all-in" cost described immediately above included the fees of KPMG, certain
14 other entities which participated in the scheme, various law firms that supplied opinion letters,
15 bank participants, and others, as well as a small portion of fees that would be used to execute the
16 purported "investments." The size of the purported "investments," the timing of the transactions,
17 and the amount of the fees were all determined based on the tax loss to be generated.

18 ***FLIP and OPIS, BLIPS, and SOS Tax Shelters***

19 19. The fraudulent tax shelter transactions designed, marketed, and/or implemented by
20 Respondent KPMG and its tax personnel which are the subject matter of this Accusation were
21 **FLIP** ("Foreign Leveraged Investment Program"), **OPIS** ("Offshore Portfolio Investment
22 Strategy"), **BLIPS** ("Bond Linked Issue Premium Structure"), **SOS** ("Short Option Strategy")
23 and their variants.¹¹

24 20. In or about 1997 through 2000, KPMG personnel, some of its clients, and others
25 involved in FLIP and OPIS tax shelter transactions prepared, signed and filed tax returns that
26 falsely and fraudulently claimed over \$ 4.2 billion in bogus tax losses generated by FLIP and OPIS
27 transactions. In or about 2000 and 2001, KPMG personnel, some of its clients, and others

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11. These shelters are described in paragraphs 26 through 42 of this Accusation.

1 involved in BLIPS tax shelter transactions prepared, signed and filed tax returns that falsely and
2 fraudulently claimed over \$ 5.1 billion in bogus tax losses generated by BLIPS transactions. In or
3 about 1999, 2000, and 2001, KPMG personnel, some of its clients, and others involved in SOS
4 tax shelter transactions prepared, signed and filed tax returns that falsely and fraudulently claimed
5 over \$ 1.9 billion in bogus tax losses generated by SOS.

6 21. A significant proportion of the taxpayers who filed tax returns with KPMG's
7 assistance using the FLIP, OPIS, BLIPS and SOS tax shelters were California taxpayers.
8 Approximately 29% of the transactions were in California and approximately 38% of KPMG's
9 fees originated in California.

10 FLIP and OPIS Shelters

11 22. FLIP was marketed and sold from at least in or about 1996 through at least in or
12 about 1999 to at least 80 wealthy individuals and generated at least \$1.9 billion in bogus tax
13 losses. KPMG's gross fees from FLIP transactions were at least \$17 million.

14 23. OPIS was marketed and sold from at least in or about 1998 through at least in or
15 about 1999 to at least 170 wealthy individuals, and generated at least \$2.3 billion in bogus tax
16 losses; KPMG's gross fees from OPIS transactions were at least \$28 million.

17 24. In all material respects, FLIP and OPIS were substantially similar. FLIP and OPIS
18 were generally marketed only to people who had capital gains in excess of \$10 million for FLIP
19 and \$20 million for OPIS.

20 25. In return for fees totaling approximately 5% to 7% of the desired tax loss, including a
21 fee to KPMG equal to approximately 1% to 1.25% of the desired tax loss, KPMG, its KPMG tax
22 personnel and their associates implemented and caused to be implemented FLIP and OPIS
23 transactions and generated and caused to be generated documentation to support the transactions,
24 including but not limited to KPMG opinion letters claiming that the purported tax losses
25 generated by the shelters were "more likely than not" to withstand challenge by the IRS.¹² As
26 agreed to, and arranged by, KPMG tax personnel, outside lawyers also issued "more likely than

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28 12. The IRS is permitted to disregard certain transactions having no economic substance or
business purpose and the purported tax effects of those disregarded transactions through a legal
doctrine, the "step transaction doctrine."

1 not" opinion letters in return for fees typically of approximately \$50,000 per opinion, which
2 opinions tracked, sometimes verbatim, the KPMG opinion letter.

3 26. These shelters were designed to generate substantial false capital losses through the
4 use of a pre-arranged series of purchases of, and options on, stock of one of two prominent
5 international banks, followed by redemptions of those investments by the bank. The minimum
6 duration of the shelters was not determined by investment performance or strategy. The tax
7 shelter transactions were devised to last for a maximum of approximately two months.

8 27. The FLIP and OPIS tax opinions signed by KPMG tax partners, and the
9 representations drafted by KPMG tax partners, for use by their clients, falsely stated that:

10 a. The client requested KPMG's opinion "regarding the U.S. federal income tax
11 consequences of certain investment portfolio transactions," when in truth and in fact these were
12 tax shelter transactions designed to generate bogus tax losses;

13 b. The "investment strategy" was based on the expectation that a leveraged position in
14 the foreign bank securities would provide the "investor" with the opportunity for capital
15 appreciation, when in truth and in fact the strategy was based on the expected bogus tax benefits
16 to be generated; and

17 c. Certain money was paid as part of an investment (i.e. for a warrant or a swap), when in
18 truth and in fact the money constituted fees due to promoters and others facilitating the
19 transaction.

20 BLIPS Shelter

21 28. BLIPS was marketed and sold from at least in or about 1999 through at least in or
22 about 2000 to at least 186 wealthy individuals, and generated at least \$5.1 billion in bogus tax
23 losses. KPMG's gross fees from BLIPS transactions were at least \$53 million.

24 29. In return for fees totaling approximately 5% to 7% of the desired tax loss, including a
25 fee to KPMG equal to approximately 1% to 1.25% of the desired tax loss, Respondent KPMG
26 and its tax personnel and associates marketed and caused to be marketed, and implemented and
27 caused to be implemented the transactions, and generated and caused to be generated
28 documentation to support the transactions. This activity included, but was not limited to,

1 generating KPMG opinion letters (and opinion letters by the law firm) that claimed that the
2 purported tax losses generated by the shelters were more likely than not to withstand challenge by
3 the IRS. All of these opinion letters were almost identical.

4 30. BLIPS was designed to generate any amount of capital and ordinary tax losses
5 through the use of a loan issued at an above-market interest rate and with a substantial "loan
6 premium" which was not in fact a true loan.

7 31. Respondent KPMG, by and through its tax personnel, issued and caused to be issued
8 opinion letters that purported to rely upon certain factual representations made by the client.
9 These representations, which were devised by KPMG tax partners and others, were false and
10 misleading, including but not limited to the following ways:

11 a. BLIPS was falsely described as a three-stage, seven-year investment program, when in
12 truth and in fact, all participants were expected to withdraw at the earliest opportunity and within
13 the same tax year in order to obtain their tax losses. BLIPS was falsely described as a "leveraged"
14 investment program, whereas, in fact, there was no "leverage" in the BLIPS transaction - the
15 negligible "investment" component was carried out and secured using only cash contributed by the
16 client.

17 b. The BLIPS opinion letters falsely stated that the client (based on the client's purported
18 "independent review", as well as that of outside "reviewers") "believed there was a reasonable
19 opportunity to earn a reasonable pre-tax profit from the [BLIPS] transactions," when there was
20 no such opportunity. The "investment" component of BLIPS was negligible, unrelated to the
21 large "loans" that were the key elements of the purported tax benefits of BLIPS, and was simply
22 window dressing for the BLIPS tax shelter fraud.

23 32. KPMG and its tax personnel and others created and caused to be created this
24 documentation in order to assist clients in claiming the bogus tax shelter losses on tax returns and
25 in evading taxes. At various points during the development of BLIPS, some KPMG tax personnel
26 identified serious and valid concerns about the honesty of the proposed opinion letter and the
27 credibility of the proposed factual representations, as well as other defects in the tax analysis
28 contained in the opinions. Nevertheless, in or about 1999, the marketing of BLIPS was

1 approved.

2 33. In or about March 2000, and prior to the issuance of any BLIPS opinion letters to
3 clients, KPMG tax leadership discussed the risks of proceeding with tax shelter transactions like
4 BLIPS, including the risk of criminal investigation, civil liability and penalties, action by the IRS's
5 Director of Professional Practice, and action by state boards of accountancy. Nevertheless,
6 despite the obvious facts about BLIPS and the warnings conveyed, KPMG tax leadership decided
7 to authorize the issuance of "more likely than not" opinion letters on all of the 1999 transactions
8 with the intent that BLIPS clients would claim the bogus BLIPS losses on 1999 tax returns.
9 Respondent KPMG and its tax personnel and others continued to implement more BLIPS tax
10 shelter transactions on 2000 tax returns and to issue opinions to support those transactions and
11 the claiming of those BLIPS losses.

12 SOS Shelters

13 34. SOS was marketed and sold from at least in or about 1998 through at least in or
14 about 2002 to at least 165 wealthy individuals, and generated at least \$1.9 billion in bogus tax
15 losses; KPMG's gross fees from SOS transactions were at least \$17 million.

16 35. The SOS shelters were referred to by various names, including Short Option
17 Strategy, Spread Option Strategy, Split Option Strategy, SOS, Binary Option, Digital Option,
18 Gain Mitigator, Loss Generator, COINS, BEST, and FX Transaction (hereinafter "SOS"). These
19 shelters were designed to generate substantial capital and ordinary tax losses through the creation
20 of an artificially high basis in an interest in a partnership or other entity through a series of
21 purchases and sales of offsetting options on foreign currency.

22 36. Between in or about 1998 and in or about 2002, for a fee to KPMG generally not less
23 than 1% of the tax losses to be generated, Respondent KPMG, through its personnel, marketed
24 and implemented SOS transactions for KPMG clients,¹³ and prepared and caused to be prepared

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28 13. For many of these SOS transactions, KPMG did not issue an opinion letter, but instead
certain "outside" lawyers issued "more likely than not" opinion letters with respect to those
transactions.

1 tax returns based on the bogus SOS tax losses.¹⁴

2 37. SOS opinion letters, and other associated documents, were false and fraudulent in a
3 number of ways, including the following:

4 a. They misrepresented SOS as an investment, when, in truth and in fact, it was a tax
5 shelter designed and marketed to generate tax losses;

6 b. They falsely claimed that the "investor" would have entered into the option positions
7 independent of the other steps that made up SOS, when, in truth and in fact, the "investors"
8 would not have entered into those positions absent the perceived advantage (anticipated tax loss);
9 and

10 c. They falsely claimed that the option positions were contributed to a partnership or
11 other entity to "diversify" the client's "investment" when, in truth and in fact, the contribution was
12 simply a necessary step in the tax shelter, and was executed for the purpose of generating the tax
13 loss.

14 **Concealment of Tax Shelters**

15 38. Respondent KPMG, through certain of its tax partners, actively took steps to conceal
16 these shelters from the IRS. These actions included:

17 a. Deciding not to register the tax shelters with the IRS as required by law;

18 b. Preparing tax returns for some high net worth individual clients in a manner which
19 made it less like likely that the IRS would learn of the clients' participation in the tax shelter;

20 c. Improperly attempting to conceal from the IRS the transactions under the veil of sham
21 attorney-client privilege claims; and

22 d. Impeding IRS and Senate investigations into the tax shelter activities.

23 ***Failing to Register Tax Shelters***

24 39. Under the law in effect at all times relevant to this Accusation, an organizer of a tax
25 shelter was required to "register" the shelter by filing a form with the IRS describing the
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27 14. KPMG marketed and implemented the SOS transactions even though KPMG personnel
28 concluded (1) that the bogus losses generated by SOS transactions were not more likely than not
to withstand IRS challenge, and (2) that draft "more likely than not" SOS opinion letters
prepared by outside law firms were not likely to withstand IRS challenge.

1 transaction. The IRS in turn would issue a number to the shelter, and all individuals or entities
2 claiming a benefit from the shelter were required to include with their income tax returns a form
3 disclosing that they had participated in a registered tax shelter, and disclosing the assigned
4 registration number.

5 40. Notwithstanding these legal requirements, KPMG leaders decided not to register tax
6 shelters, notwithstanding advice to the contrary from KPMG personnel, and a warning, on at least
7 one occasion, from KPMG personnel, that a willful failure to register the shelters could be
8 criminal conduct. A KPMG tax partner, the head of the CaTS practice, wrote a memorandum to
9 an official at the highest KPMG management level asserting that KPMG should make a "business
10 decision" not to register OPIS because (1) registering the shelters would put KPMG at a
11 competitive disadvantage as compared to other accounting firms, law firms, and other firms that
12 were promoting tax shelters; and (2) selling unregistered shelters would be so lucrative that the
13 benefits outweighed the risk of civil penalties that might be imposed. Other members of top
14 management concurred in this "business decision," notwithstanding the risks involved.

15 *Concealing Shelter Losses and Income on Tax Returns*

16 41. KPMG's tax personnel, and others prepared, and caused to be prepared, tax returns
17 that were false and misleading and were intended to conceal the tax shelters from the IRS in a
18 number of ways, including but not limited to the methods described immediately following.

19 42. Grantor Trust Netting. Although the law requires that an individual's items of
20 income, gain, and loss be reported on an individual income tax return, some tax returns prepared
21 for FLIP, OPIS, and BLIPS clients used grantor trusts to hide the tax shelter losses (and the gains
22 they were designed to shelter) on the clients' individual income tax returns.¹⁵ Instead of reporting
23 the bogus tax shelter losses and the income or gains that were to be sheltered on the client's
24 individual income tax return, only the net of those two figures was reported on the individual

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26 15. A grantor trust is a trust that, because of certain features enumerated in the tax code, is
27 disregarded as an entity for federal income tax purposes. A scheme was devised to insert a
28 grantor trust into a tax shelter transaction, and then, rather than disregarding the grantor trust as
required by the tax code, reporting the large phony tax shelter loss, and the taxable gain or
income those losses were used to offset, only on the grantor trust Information return, while
reporting only the small net of those numbers on the client's individual income tax return.

1 client's tax return. Although the suggestion was raised within KPMG that pursuing this "grantor
2 trust netting" scheme was not a proper reporting position, and in fact might be criminal, a leader
3 of KPMG's PFP group instructed KPMG tax partners that each individual tax partner could
4 decide for himself or herself whether to advise clients to engage in grantor trust netting.

5 43. Stock Sales. In order to conceal tax shelter losses from the IRS, KPMG tax
6 personnel advised at least one client that phony tax shelter losses could be concealed and made to
7 look like losses from the sale of a number of publicly traded stocks, and worked with others, who
8 purchased publicly traded stock on behalf of the shelter client, and then distributed those stocks to
9 the client upon the client's withdrawal from the transaction. In order to so conceal the losses, the
10 shelter was concealed on the client's tax return because the return instead reported the purported
11 tax shelter losses as losses resulting from the sale of the stock so distributed.

12 44. Sham Attorney-Client Privilege. One KPMG tax partner from the Stratecon group
13 attempted to conceal tax shelter activities by attempting to cloak communications regarding those
14 activities and certain of the activities themselves with the attorney-client privilege. He purported
15 to have KPMG clients engage a law firm to provide legal advice, which law firm would then
16 purport to engage KPMG to work under its (the law firm's) direction. The purpose of this
17 improper conduct was to enable the client to conceal the fraudulent tax shelter from the IRS by
18 attempting to cloak all of the work for the shelter in the attorney-client privilege. Numerous
19 "privileged" arrangements purportedly established by that KPMG tax partner with a law firm were
20 sham arrangements because the clients did not directly engage the law firm, and in many instances
21 never even spoke to anyone at the firm.

22 *Impeding IRS and U.S. Senate Investigations*

23 45. In or about September 2001, the IRS initiated an examination of Respondent KPMG
24 for its failure to register the transactions with the IRS. As part of this examination, in or about
25 early 2002, the IRS issued approximately 25 summonses to Respondent KPMG calling for the
26 provision of information relating to numerous tax shelters with which KPMG may have been
27 involved. In addition, the IRS summonses required KPMG to designate a knowledgeable person
28 to testify under oath at the IRS. The testimony which resulted was false, misleading, and/or

1 evasive.

2 46. One of the IRS summonses called for production of documents relating to SOS tax
3 shelters, among other things. KPMG's involvement in marketing and implementing SOS
4 transactions was well known to several members of KPMG's tax leadership and certain partners
5 responsible for responding to the summonses. Nevertheless, none of the SOS tax shelters
6 marketed or implemented by KPMG were disclosed to the IRS until late 2003 and early 2004.
7 On at least one occasion, a KPMG tax partner falsely advised that the only role that KPMG
8 played with respect to SOS was to assist a couple of clients in preparing and filing tax returns that
9 reflected the tax losses from SOS transactions.

10 47. In January 2003, the Permanent Subcommittee on Investigations, of the U.S. Senate's
11 Committee on Homeland Security and Governmental Affairs, hereinafter the "Senate
12 Subcommittee," issued a subpoena to KPMG calling for documents and information relating to its
13 tax shelter activities, including a specific request for documents relating to tax shelters used by
14 KPMG partners to avoid their own taxes. Although KPMG was in possession of numerous
15 documents responsive to that request, in February 2003 KPMG stated that "to the best of its
16 knowledge and belief, after reasonable inquiry to date, the firm has not yet identified any
17 documents that are responsive to this request."

18 48. In or about November 2003, KPMG tax personnel testified, individually or in panel
19 format, before the Senate Subcommittee investigating tax shelter activities of KPMG and others.
20 The Minority Staff of the Senate Subcommittee issued a report in 2003 entitled "*U.S. Tax Shelter*
21 *Industry: The Role of Accountants, Lawyers, And Financial Professionals*" (the "Minority Staff
22 Report") that included relevant documents obtained by the Subcommittee, including KPMG
23 internal e-mails, which demonstrated that KPMG personnel acted in concert with other entities or
24 individuals in developing and marketing the tax products at issue. On February 8, 2005, the
25 Senate Subcommittee released its final report, entitled "*The Role of Professional Firms in the*
26 *U.S. Tax Shelter Industry*" (the "Senate Report"). According to the report, much of the
27 testimony on behalf of KPMG was false or evasive.

28 //

1 **Proceedings in United States District Court, Southern District of New York**

2 49. Criminal proceedings related to the tax shelters have been underway since 2006 in
3 United States District Court, Southern District of New York, which proceedings are summarized
4 in part in the accompanying footnote.¹⁶ However, the matter has been resolved as to KPMG as
5 described in the paragraphs which follow immediately.

6 **KPMG's Deferred Prosecution Agreement**

7 50. On or about August 26, 2005, the United States Attorney's Office for the Southern
8 District of New York and KPMG entered into a Deferred Prosecution Agreement ("DPA" or
9 "Agreement"), which included a Statement of Facts and an Information, as summarized below.

10 51. KPMG consented to the filing of a one-count Information in the United States
11 District Court for the Southern District of New York charging KPMG with participating in a
12 conspiracy in violation of 18 U.S.C. §371 to (i) defraud the United States and its agency
13 the Internal Revenue Service; (ii) commit tax evasion in violation of 26 U.S.C. §7201; and (iii)
14 make and subscribe false and fraudulent tax returns, and aid and assist in the preparation and filing

15
16
17 16. In United States District Court, Southern District of New York, a Superseding
18 Indictment was filed on or about October, 2006, against nineteen individual defendants, most of
19 whom are former KPMG tax personnel, in *U. S. v. Stein et al.* (Complete Caption: *United States*
20 *of America against Jeffrey Stein, John Lanning, Richard Smith, Jeffrey Eischeid, Philip*
21 *Wiesner, John Larson, Robert Pfaff, David Amir Makov, Larry DeLap, Steven Gremminger,*
22 *Raymond J. Ruble, Gregg Ritchie, Randy Bickham, Mark Watson, Carol Warley, David Rivkin,*
23 *Carl Hasting, Richard Rosenthal and David Greenberg, Defendants*), Case No. S1 05 Cr. 888
24 (LAK). The Superseding Indictment replaced the Indictment filed in *U.S. v. Stein et al.*, in or
25 about late August 2006, in which KPMG was named as an unindicted co-conspirator. The
26 **Superseding Indictment** charged the defendants with conspiracy and tax evasion. One of the
27 defendants, David Rivkin, was convicted on March 27, 2006, by his pleas of guilty, in the
28 United States District Court, Southern District of New York, in Case No. S2 05 Cr.888 (LAK),
United States v. David Rivkin, of one felony violation of 18 U.S.C. Section 371 (conspiracy)
and one felony violation of 18 U.S.C. Section 7201 (tax evasion), violations of federal law,
pursuant to a *Superseding Information*. Rivkin's CPA certificate has subsequently been
disciplined by the California Board of Accountancy in its Case No. 2006-33.

Separately, another of the defendants, David Amir Makov, was convicted on September
10, 2007, by his plea of guilty, in United States District Court, Southern District of New York,
in *United States v. David Amir Makov*, Case No. S3 05 Cr.888 (LAK), of one felony violation
of 18 U.S.C. Section 371 (conspiracy) pursuant to a *Superseding Information*. The remaining
defendants have not yet been tried, and cases against certain of the defendants have been
dismissed.

1 of said tax returns in violation of 26 U.S.C. §7206.¹⁷

2 52. KPMG entered a plea of not guilty to the Information, but admitted and accepted
3 that, as set forth in the **Statement of Facts** attached to the DPA,

4 "[f]rom 1996 through 2002, KPMG, through its tax partners, assisted
5 high net worth United States citizens to evade United States individual
6 income taxes on billions of dollars in capital gain and ordinary income by
7 developing, promoting, and implementing unregistered and fraudulent tax shelters.
8 A number of KPMG tax partners engaged in conduct that was
9 unlawful and fraudulent, including: (i) preparing false and fraudulent tax
10 returns for shelter clients; (ii) drafting false and fraudulent proposed factual
11 recitations and representations as part of the documentation underlying the
12 shelters; (iii) issuing opinions that contained those false and fraudulent statements
13 and that purported to rely upon those representations, although the KPMG tax
14 partners and the high net worth individual clients knew they were not true;
15 (iv) actively taking steps to conceal from the IRS these shelters and the true

16 ///

17 17. Relevant sections of the United States Code provide as follows:

18 A. Title 18 (Crimes and Criminal Procedure), Section 371 (Conspiracy) provides, in
19 relevant part, that "[i]f two or more persons conspire either to commit any offense against the
20 United States, or to defraud the United States, or any agency thereof in any manner or for any
21 purpose, and one or more of such persons do any act to effect the object of the conspiracy, each
22 shall be fined under this title or imprisoned not more than five years, or both." [18 U.S.C.
23 §371] Title 18 (Crimes and Criminal Procedure)

24 B. Title 26 (Internal Revenue Code), Section 7201 (Tax Evasion), provides that "[a]ny
25 person who willfully attempts in any manner to evade or defeat any tax imposed by this title or
26 the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony
27 and, upon conviction thereof, shall be fined not more than \$10,000, or imprisoned not more than
28 5 years, or both, together with the costs of prosecution." [26 U.S.C. §7201]

29 C. Title 26 (Internal Revenue Code), Section 7206 (Fraud and False Statements)
30 provides, *inter alia*, that "[a]ny person who (1) Willfully makes and subscribes any return,
31 statement, or other document, which contains or is verified by a written declaration that it is
32 made under the penalties of perjury, and which he does not believe to be true and correct as to
33 every material matter; or (2) Willfully aids or assists in, or procures, counsels, or advises the
34 preparation or presentation under, or in connection with any matter arising under, the internal
35 revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as
36 to any material matter, whether or not such falsity or fraud is with the knowledge or consent of
37 the person authorized or required to present such return, affidavit, claim, or document...shall be
38 guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000
in the case of a corporation), or imprisoned not more than 3 years, or both, together with the
costs of prosecution. [26U.S.C. §7206]

1 facts regarding them; and (v) impeding the IRS by knowingly failing
2 to locate and produce all documents called for by IRS summonses
and misrepresenting to the IRS the nature and extent of KPMG's
3 role with respect to certain tax shelters."

4 The Statement of Facts is excerpted below and is attached hereto and **incorporated**
5 **herein in its entirety as Exhibit A.**

6 53. The DPA, based upon KPMG's admissions and acceptance of responsibility as set
7 forth in the Agreement and the Statement of Facts attached thereto, has many components,
8 including:

9 A. KPMG agreed to "permanent restrictions and elevated standards" for its tax practice,
10 including ceasing its private client tax practice and ceasing its compensation and benefits tax
11 practice by February 28, 2006. It agreed, except as specifically provided in the agreement, not to
12 prepare tax returns, or provide tax advice of any kind to any individual clients. It agreed not to
13 develop, market, sell, or implement (or assist in so doing) any pre-packaged tax product, nor
14 "covered opinion" with respect to any "listed transaction." It agreed not to provide any tax
15 services under any conditions of confidentiality, and agreed not to charge or accept fees subject to
16 contractual protection or any fees that are not based exclusively on the number of hours worked
17 at set hourly rates (additional definitions and provisions are contained in the agreement). KPMG
18 agreed to comply with the ethics and independence rules concerning independence, tax services,
19 and contingent fees as adopted by the Public Company Accounting Oversight Board.

20 B. KPMG agreed to comply with certain minimum opinion thresholds and minimum
21 return position threshold as provided in the agreement. KPMG agreed not to rely on an opinion
22 issued by other professional firms to determine whether it complies with the minimum standards
23 set forth above unless KPMG concurs with the conclusions of such opinion. With respect to its
24 federal, state and local tax controversy representation, KPMG agreed to certain restrictions in
25 representing persons or entities, agreed not to defend a "listed transaction" and agreed not to
26 defend (after February 28, 2006) any transaction with respect to which the firm could not render
27 an opinion or prepare a return in compliance with the standards set forth in the agreement.

28 C. KPMG agreed to pay a total of \$456,000,000 to the United States as part of the

1 Agreement, as follows: a fine consisting of disgorgement of \$128,000,000 of fees received by
2 KPMG from the activities described in the Statement of Facts; restitution to the IRS of
3 \$228,000,000 for actual losses suffered as a result of, among other things, the running of statutes
4 of limitations because of, among other things, KPMG's failure to register its tax shelters, KPMG's
5 failure to disclose its participation in certain fraudulent shelter transactions to the IRS in response
6 to summonses, and KPMG's misrepresentation to the IRS of its involvement in those
7 transactions, as detailed in the Statement of Facts; and an IRS penalty of \$100,000,000 to settle
8 (pursuant to a Closing Agreement¹⁸), the IRS's promoter penalty examination of KPMG. No
9 part of the \$456,000,000 is deductible on any Federal or State tax or information return. No
10 portion of the \$456,000,000 was to be covered by any insurance policy in existence at the time of
11 the conduct (additional provisions regarding insurance coverage are contained in the agreement).

12 D. KPMG agreed to implement and maintain an effective compliance and ethics program,
13 including its maintenance of a permanent compliance office and a permanent educational and
14 training program relating to the laws and ethics governing the work of KPMG's partners and
15 employees, paying particular attention to practice areas that pose high risks. KPMG agreed to
16 oversight and monitoring by a "Monitor" appointed by the U. S. Attorney.

17 E. KPMG agreed to cooperate fully and actively with the U. S. Attorney's Office, the
18 IRS, and with any other agency of the government related to the Office's investigation, as defined
19 in the Agreement.

20 54. Based upon KPMG's commitments as set forth in the DPA, the U. S. Attorney's
21 office agreed to recommend that the prosecution of KPMG on the Information be deferred for the
22 period through December 31, 2006. The U. S. Attorney's Office agreed to seek, at the expiration
23 of the period, dismissal without prejudice as to KPMG of the Information filed against KPMG.

24 Completion of the Deferred Prosecution Agreement

25 55. Based upon KPMG's compliance with the terms of the Deferred Prosecution
26 Agreement, the Information was dismissed on January 3, 2007.

27
28 18. The Closing Agreement entered with the IRS provided for enhanced oversight and
regulatory compliance and resolved the IRS examination of KPMG for certain alleged
violations.

FIRST CAUSE FOR DISCIPLINE
Fraud in the Practice of Public Accountancy
[Business and Professions Code § 5100(c)]

56. Complainant realleges paragraphs 11 through 48 and 52 above, and incorporates them herein by reference as if fully set forth at this point.

57. As set forth above, Respondent's activity included devising, marketing and implementing fraudulent tax shelters (FLIP, OPIS, BLIPS and SOS), and, in so doing, creating or procuring false and fraudulent "opinion letters" and other documents. Respondent's tax personnel engaged in one or more instances of fraud with respect to each tax shelter devised, marketed and/or implemented, constituting fraud in the practice of public accountancy within the meaning of Code Section 5100(c) and establishing multiple causes for discipline of Respondent KPMG LLP's partnership registration under Code Sections 5100 and 5101.

58. As set forth above, Respondent's activity included preparing, signing and filing tax returns that falsely and fraudulently claimed tax losses generated by FLIP, OPIS, BLIPS and SOS. Respondent's tax personnel engaged in fraud with respect to each tax return that fraudulently claimed tax losses, constituting fraud in the practice of public accountancy within the meaning of Code Section 5100(c) and establishing multiple causes for discipline of Respondent KPMG LLP's partnership registration under Code Sections 5100 and 5101.

59. As set forth above and referencing in particular paragraphs 38 through 46, Respondent and its tax personnel fraudulently concealed the tax shelters from the taxing authorities, constituting fraud in the practice of public accountancy within the meaning of Code Section 5100(c), establishing cause for discipline of Respondent KPMG LLP's partnership registration under Code Sections 5100 and 5101.

SECOND CAUSE FOR DISCIPLINE
Gross Negligence in the Practice of Public Accountancy
[Business and Professions Code § 5100(c)]

60. Incorporating by reference the matters alleged in paragraphs 11 through 38, 40, and 52, KPMG's partnership license is subject to disciplinary action in that the conduct described constitutes gross negligence, that is, multiple instances of extreme departures from applicable professional standards, including the requirements for representing tax clients, within the meaning

1 of Code Section 5100(c), establishing cause for discipline under Code Sections 5100 and 5101.

2 **THIRD CAUSE FOR DISCIPLINE**
3 **Dishonesty in the Practice of Public Accountancy**
4 **[Business and Professions Code § 5100(c)]**

5 61. Complainant realleges paragraphs 11 through 48 and 52 above, and incorporates them
6 herein by reference as if fully set forth at this point.

7 62. As set forth in paragraph 46 above, Respondent responded falsely to IRS document
8 summonses, in that the shelters marketed or implemented by KPMG were not disclosed, in that
9 KPMG personnel caused KPMG falsely to claim to the IRS that the production was substantially
10 complete, and in that KPMG's personnel caused KPMG representatives falsely to respond that
11 KPMG was not involved in SOS, said conduct constituting dishonesty in the practice of public
12 accountancy within the meaning of Code Section 5100(c) and establishing cause for discipline of
13 Respondent KPMG LLP's partnership registration under Code Sections 5100 and 5101.

14 63. As set forth in paragraphs 45, 47 and 48 above, Respondent produced witnesses to
15 the IRS and the U. S. Senate Permanent Subcommittee on Investigations whose testimony was
16 false, misleading or evasive, said conduct constituting dishonesty in the practice of public
17 accountancy within the meaning of Code Section 5100(c) and establishing cause for discipline of
18 Respondent KPMG LLP's partnership registration under Code Sections 5100, and 5101.

19 64. As set forth in paragraph 44 above, Respondent and its tax personnel attempted to
20 conceal fraudulent tax shelter activities by misuse of the attorney-client privilege, said conduct
21 constituting dishonesty in the practice of public accountancy within the meaning of Code Section
22 5100(c) and establishing cause for discipline of Respondent KPMG LLP's partnership registration
23 under Code Sections 5100 and 5101.

24 **FOURTH CAUSE FOR DISCIPLINE**
25 **Knowing Preparation of False, Fraudulent or Materially Misleading Information**
26 **[Business & Professions Code § 5100j]**

27 65. Complainant realleges paragraphs 11 through 48 and 52 above, and incorporates them
28 herein by reference as if fully set forth at this point.

66. Incorporating herein the matters set forth in paragraph 65, Respondent prepared false
information in devising, marketing and implementing fraudulent tax shelters (FLIP, OPIS, BLIPS

1 and SOS), including its preparation of, or procurement of, false and fraudulent "opinion letters"
2 and other documents. Respondent's tax personnel's conduct constitutes multiple instances of the
3 knowing preparation of false, fraudulent or materially misleading information, constituting
4 multiple violations of Code Section 5100(j) and establishing multiple causes for discipline of
5 Respondent KPMG LLP's partnership registration under Code Sections 5100 and 5101.

6 67. As set forth above, Respondent's fraudulent activity included preparing, signing and
7 filing tax returns that falsely and fraudulently claimed tax losses generated by FLIP, OPIS, BLIPS
8 and SOS, each constituting the preparation of false, fraudulent or materially misleading
9 information, and severally constituting multiple violations of Code Section 5100(j) and
10 establishing multiple causes for discipline of Respondent KPMG LLP's partnership registration
11 under Code Sections 5100 and 5101.

12 **FIFTH CAUSE FOR DISCIPLINE**
13 **Willful Failure to Observe Professional Standards**
14 **[Board Rule 58/Bus. & Prof. Code § 5100(g)]**

15 68. Incorporating by reference the matters alleged in paragraphs 11 through 38, 40
16 through 44, and 52, KPMG's partnership license is subject to disciplinary action in that the
17 conduct described constitutes multiple instances of the violation of applicable professional
18 standards, including the requirements for representing tax clients, within the meaning of Board
19 Rule 58, establishing cause for discipline under Code Sections 5100(g) and 5101.

20 **SIXTH CAUSE FOR DISCIPLINE**
21 **Conspiracy with Unlicensed Person to Violate Accountancy Act**
22 **[Business & Professions Code §§125/5100]**

23 69. Complainant realleges paragraphs 11 through 48 above, in particular the matters
24 alleged in paragraphs 13, 14, 19, 20, 25, 26, 29, 31, 32, 41, 43, and 44, and incorporates them
25 herein by reference as if fully set forth at this point.

26 70. Incorporating herein the matters set forth in paragraph 69, Respondent, through its
27 licensed tax personnel, conspired with persons not so licensed, including former licensees,
28 lawyers, bank personnel and "boutique" or purported investment firms, to devise, market and/or
implement the fraudulent tax shelters, which conduct subjects the Respondent to the disciplinary
provisions of the Accountancy Act and constitutes cause for discipline of the KPMG partnership

1 registration under Code Section 125 in conjunction with Code Section 5100 and 5101.

2 **COST RECOVERY**

3 71. Pursuant to Code Section 5107, it is requested that the administrative law judge, as
4 part of the proposed decision in this proceeding, direct the Respondent to pay to the Board all
5 reasonable costs of investigation and prosecution incurred in these matters, including, but not
6 limited to, attorneys' fees.

7 **PRAYER**

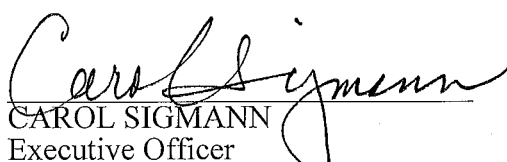
8 WHEREFORE, Complainant requests that a hearing be held on the matters herein alleged,
9 and that following the hearing, the California Board of Accountancy issue a decision:

10 1. Revoking, suspending or otherwise imposing discipline upon Certified Public
11 Accountant Partnership Registration No. PAR 157, issued to KPMG LLP;

12 2. Ordering KPMG to pay the California Board of Accountancy the reasonable costs of
13 the investigation and enforcement of this case, pursuant to Business and Professions Code
14 Section 5107; and

15 3. Taking such other further action as may be deemed proper.

16 DATED: January 7, 2008.

17 
18 CAROL SIGMANN
19 Executive Officer
20 California Board of Accountancy
21 Department of Consumer Affairs
22 State of California
23 Complainant
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